APPENDIX N
Guest Articles
Discussing LIHTC Compliance Issues

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PROPERTY COMPLIANCE REPORT

A MONTHLY PUBLICATION ON LOW-INCOME HOUSING TAX CREDIT COMPLIANCE

August 2001, Volume IV, Issue VIII, Published By Novogradac & Company LLP

Thinking About Year 15 of a Low-Income Housing Tax-Credit Partnership

By Ronald A. Shellan, Esq., Miller Nash LLP

(First of two parts)

As the compliance period for some earlier low-income housing tax-credit projects expires in the next few years, it is time for the industry to focus on exactly what will happen to these projects.

It is also appropriate to negotiate terms and provisions to the typical partnership agreement, permanent loan documentation, and right-of-first-refusal agreements that allow the statutory right-of-first-refusal agreement and qualified contract to fully operate in accordance with the expectation of the parties.

Most efforts in developing low-income housing projects have been based on negotiating the transaction between the developer and the investor. While we hoped we would not be dead in 15 years, 15 years seemed an awfully long time away and not a lot of time or effort was spent in evaluating just how the partnership would terminate. Because of investor expectations and provisions of the Internal Revenue Code, however, many a project will be acquired by its general partner after the 15-year compliance period. The purpose of this article is to review year-15 issues and think about the documentation that should be prepared to deal with those issues when a transaction closes.

The low-income housing tax credit was first passed by Congress in 1986. For early projects whose year 15 will be coming soon, the industry will need to address three primary issues:

- How will the right of first refusal granted to most nonprofit developers operate in year 15?
- How and when will for-profit developers seek a qualified contract for the project to go to market in year 15?
- What happens if the general partner for some reason will not or cannot purchase the low-income housing project after the compliance period?

Right of First Refusal

A project will not lose its tax benefits if there is a right of first refusal in favor of a qualified nonprofit organization, government agency, or any of certain other tenant organizations to purchase the low-income buildings for debt plus taxes resulting from the purchase. Without this special provision in the Internal Revenue Code, a partnership that owns a project subject to a below-market option will not be treated as the owner of the project for tax purposes and will not be entitled to any deductions such as depreciation or interest related to the project.

The right of first refusal appears to cover only buildings and not to reserves and personal property, although there is a reference to “property” in Section 41(i)(7). The IRS could easily take the position that only the buildings are covered by the right of first refusal. The other assets of the partnership, which might include reserves, furniture, equipment, or accounts receivable for unpaid rents or other unpaid claims, appear not to be covered under the right-of-first-refusal agreement.

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Under a typical partnership agreement, reserves, furniture, equipment, and accounts receivable would be converted into cash upon acquisition of the project, and the partnership liquidated. In most cases, 99 percent of the value of the assets would be distributed to the investor limited partner.

To avoid reserves being allocated to the investor limited partner, reserves can be spent prior to the exercise of the right of first refusal to pay down permanent debt or improve the property.

Lender Concerns

Lenders are usually uncomfortable using operating reserves for anything but emergencies, including paying down debt or providing unneeded improvements. To allay such concerns, the lender can be offered conditions that include:

- Reserves may not be used to pay down debt or improve the project until after year 14 of the project;
- The project has a 1.10 or greater debt-coverage ratio; and
- The project must not be in default on its obligations to the permanent lender.

Investor Limited Partner Concerns

While investor limited partners seem agreeable to spending reserves even though this is money that would otherwise go to them in year 15, the partnership agreement must be structured to provide that the money can be spent to pay down debt or improve the property without obtaining the approval of the investor limited partner. The provisions should be parallel to the provisions negotiated with the permanent lender.

Any options to purchase reserves or personal property and equipment for $1 may mean that the amounts for furniture and equipment cannot be depreciated because the partnership would not be deemed to be the "owner" of the furniture or equipment for tax purposes. Such an option might be attacked by the IRS, which could assert that payments for reserves are really payments to the not- for-profit partner. If so, the IRS could take the position that the not-for-profit partner has greater than a 1 percent interest in the partnership and thus runs afoul of the tax-exempt use rules. In this event, depreciation on the entire project would be changed from 27.5 years to 40 years.

The IRS could also assert that payments from reserves to pay for an expense are not deductible because the expense was not paid for by the partnership, but was really paid for by the not-for-profit general partner.

In computing the purchase price, debt assumed under the right of first refusal will not include unsecured debt. Therefore, unsecured debt owed to anyone who is not the not-for-profit general partner may not be paid unless there are other assets in the partnership to pay this debt. There may be debtor-creditor issues (such as the possibility of a fraudulent transfer) if a

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creditor is not paid and reserves have been used in such a way that the obligations to the creditor are avoided.

Tax Obligations

The actual amount of taxes paid by the partners might be difficult to determine if there is a fund made up of many investors, some of whom could be in high tax brackets and some of whom might have losses that could offset the income.

For many limited partnerships, no taxes will result from a sale of the property for the debt. For a limited partnership, no taxes will be due unless the limited partner has a negative capital account. Projections show that most but not all limited partners will have a positive capital account in year 15.

Unless regulations that settle the matter are issued, the following areas are fertile for argument:

- Should the federal taxes generated by the sale be reduced by the state and local taxes generated by the sale that can be deducted in computing federal taxable income?
- Should the state and local taxes generated by the sale be reduced by the federal income tax savings generated by the taxes?
- The answer as between (a) and (b) above might mean that the federal taxes are grossed up, but would be a smaller number because of the state and local tax deduction.
- Should the right-of-first-refusal agreement attempt to solve this problem?

An alternative to the nonprofit general partner's being granted a right of first refusal to purchase the real estate owned by the partnership is for the nonprofit general partner to have a right of first refusal to purchase the partnership interest owned by the investor limited partner.

Part two of Ronald Shellan's article on Year 15 will appear in the September issue of Novogradac & Company LLP's "Property Compliance Report."

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PROPERTY COMPLIANCE REPORT

A MONTHLY PUBLICATION ON LOW-INCOME HOUSING TAX CREDIT COMPLIANCE

September 2001, Volume IV, Issue IX, Published By Novogradac & Company LLP

Low Income Housing Tax Credit Partnerships: Thinking About the Year-15 Transition

By Ronald A. Shellan, Esq., Miller Nash LLP

Part 2

Last month, the first in this series of two articles discussed lender and investor limited partner concerns and tax obligation considerations when negotiating terms and provisions on expiring compliance periods for some early low-income housing tax credit projects. This month's article looks at the issues of a right of first refusal

Right of First Refusal vs. Option

A right of first refusal is not an option. An option is triggered by the actions of the not-for-profit general partner, but a right of first refusal is triggered by a proposed purchaser's making an offer to purchase the property.

Can an option be used instead of a right of first refusal? Although the two concepts arguably have no practical difference in private discussions, Internal Revenue Service personnel have indicated that they would attack an option as not being within the safe-harbor provision.

It also appears very unlikely that a low-income project that is subject to a valid right of first refusal would generate a truly bona fide purchase offer. Why would a real estate broker be interested in attempting to sell a building that was subject to a right of first refusal to purchase it, in most cases by only assuming the debt? There is no incentive for a potential investor to take the time to investigate and make an offer to purchase property if there is virtually no chance that the offer will be accepted.

What can the not-for-profit do? It will probably try to persuade one of its board members or another not-for-profit to offer to purchase the property. In these circumstances, there is no real intent to purchase the property.

Are there problems with purchasing the property if a less than bona fide offer has been received? The best guess is that there would not be a problem because the investor limited partner probably wants out of the property. It planned to invest in the property for only 15 years and the time has passed. The property may have stopped producing tax losses and may now, or shortly, start producing phantom income.

But if the property is producing substantial returns for the investor limited partner, the investor might object to the sale and insist on a bona fide offer that will never come. Later, the property will be sold, after the right of first refusal is no longer applicable, at its market price, producing a windfall for the investor limited partner.

Additionally, the IRS certainly has an interest in making sure that the right-of-first-refusal formula complies with all the provisions of Section 42. But it is hard to think of a concern it might have if the parties ignored the spirit of the right of first refusal and closed the transaction based on a less than bona fide offer.

The Agreement

A right-of-first-refusal agreement should generally contain a number of specific provisions to protect the rights of

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the investor and not-for-profit. It should not be exercisable by the not-for-profit if any of the following occurs:

- The not-for-profit is not a qualified not-for-profit organization at the time the right of first refusal is exercised.
- The partnership agreement and the obligations of the general partner to the limited partner under the partnership agreement are in default.
- The not-for-profit or its affiliate is no longer the general partner of the partnership.

If notice of the existence of a right-of-first-refusal agreement is recorded in the deed records, the agreement should provide that the not-for-profit will issue a quitclaim deed to clear title if it is not exercised.

It generally makes sense to include an option to purchase the property at fair market value. An option can be granted a for-profit general partner. The option need not be subject to any of the above restrictions because the interests of the investor limited partner are not hurt if the property is purchased for fair market value.

Term of Right of First Refusal

The right-of-first-refusal term should start at the end of the compliance period. The end of the term from the point of view of the investor limited partner should be short (less than a year) in order to force the not-for-profit to purchase the property and to possibly take advantage of the not-for-profit's failure to act within fairly short time limits. Further, if the not-for-profit fails to exercise its rights, the investor limited partner will benefit because the project will be sold either for its market value considering the restricted rents, or at the qualified contract price .

The not-for-profit wants as long a term as possible to give it the greatest flexibility to act. If it must accept a short term, it should attempt to negotiate a notice provision from the investor limited partner so that the term does not expire without the not-for-profit's knowledge.

Qualified Contract

Unless contractually waived, a project can become a market-rate project after the 15-year extended-use period. To do so, it must be offered to the tax credit agency beginning on or after the 14th year of the extended-use period for a year. During that period, the tax credit agency can locate a qualified purchaser to purchase the project for its debt plus the taxpayer's investment in the project (adjusted for inflation, not to exceed a 5 percent increase per year). Existing tenants will be able to enjoy low-income rents for as many as three years after the project becomes a market rate project.

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For a for-profit or a not-for-profit that does not have an option and right of first refusal, there are reasons to buy for fair market value, including the ability to obtain control of property and not deal with the investor, or if the project has sufficient equity to finance the purchase.

The reasons not to buy for fair market value include: a general partner who is not viable or interested in this type of investment; no significant increase in cash flow will occur as a result of not buying out the investor; mortgage restrictions; a project that will not support additional debt; the deterioration of the financial strength of the general partner; and interest rates that are such that the project is temporarily not financeable.

Even a not-for-profit with a right of first refusal may not exercise its right if the project has no equity or very little equity, or if the not-for-profit is in financial difficulties.

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Tax Credit Advisor **newsletter, January 2002**

Combining Tax Credits and Tax-Exempt Bonds: Understanding the Differences

Part 1 of 2

By A.J. Johnson

In the early days of the low-income housing tax credit program, tax credits were often used alone or in conjunction with the Farmers Home Section 515 rural rental housing loan program. Urban properties were usually developed as "stand-alone" tax credit deals with conventional or state-assisted financing. A complex mixing of various housing programs was something to be avoided, especially in a 9 percent tax credit project.

In fact, until the mid-1990s, it was widely believed that combining tax credits and tax-exempt bonds would only work for rehabilitation projects, since new construction required raising large amounts of equity possible only with the 9 percent credit. [Tax-exempt bond-financed projects are limited to the 4 percent credit for new construction or substantial rehabilitation costs.]

However, as competition for 9 percent tax credits intensified, developers were forced to be more creative in structuring credit deals. It became necessary to combine the tax credit with tax-exempt bonds, federal HOME funds, HUD Section 8 rent subsidies, Section 515 loans, and, more recently, HUD HOPE VI grants.

This two-part article is intended to provide developers and property managers with information and guidance on how to combine housing tax credits with these other housing programs, to assure continuous compliance with their varied requirements.

Part 1 of the article (this installment) will cover the combination of tax credits and tax-exempt private activity bonds – the most common marriage. Part 2, in a few months, will cover the use of the credit with other federal programs.

Combining Bonds and Credits

The federal requirements governing the use of tax-exempt bonds to finance affordable multifamily rental housing projects are found in Section 103 of the Internal Revenue Code and IRS regulations Section 142(d). The credit program is governed by Section 42 of the Code and myriad IRS regulations, notices, etc.

Each program has its own set of compliance requirements, which project owners and managers should be familiar with in order to successfully combine the two incentives.

Developers have shown growing interest for several years in tax-exempt financing for their projects. The primary motivation is simple: If at least 50 percent of the cost of a project is financed by tax-exempt private activity bonds, the 4 percent tax credit may be claimed for all eligible project costs without having to compete in the state's competitive allocation cycle for 9 percent credits. Once a project gets an allocation of bond authority, and meets certain minimum requirements of the housing credit agency, the receipt of credits is virtually assured.

Minimum Set-Asides

Both the credit and bond programs impose the same minimum set-aside requirements. An election must be made either to meet the "20/50" or "40/60" set-aside test.

Under the former, at least 20 percent of the units in the project must be rented to households at or below 50 percent of the HUD-set area median income (AMI), adjusted for household size. Alternatively, at least 40 percent of the units must be rented to households at or below 60 percent of the AMI.

For projects in New York City only, the 40/60 test is replaced by a 25/60 test.

A special additional targeting requirement for both bonds and credits applies to mixed-income properties that the owner elects to be treated as a "deep rent-skewed project." In these, at least 15 percent of the low-income units (i.e., 15 percent times 20 or 40 percent) must be rented to households at or below 40 percent of the AMI.

For tax credit purposes, the owner of the project is the one to select the particular minimum set-aside requirement for the property. Under the bond program, the issuer of the bonds makes this election. Therefore, it's possible to have a project using both credits and bonds that will have one set-aside requirement for the tax credit and a different set-aside requirement for the bonds. This is one reason for carefully reviewing the regulatory documents for both programs.

As a general rule, in areas where the requirements differ for credits and for bonds (or differ between the credit and other federal programs), the tougher of the two sets of standards should be followed. This will assure compliance with all of the programs used for the project.

Rent Restrictions

Except for deep rent-skewed projects, there are no rent restrictions for units in bond-financed projects. Keep in mind, however, that individual bond-issuing agencies may impose rent limits. These restrictions should be outlined in the bond regulatory agreement.

The tax credit program, on the other hand, imposes rent restrictions on the low-income units that make up the minimum set-aside percentage. Under this set of rules, the gross rent for a low-income unit can't exceed 30 percent of the income limit for a qualified household of the assumed size for that particular unit (i.e., the imputed size). The actual size of the household doesn't matter in determining the gross rent limit, though it does matter in determining whether a household meets the income cap for a tax credit unit.

For units with no bedrooms, the imputed household size is one person. For larger units, the imputed size is 1.5 persons per bedroom. Therefore, for a two-bedroom apartment, the rent limit would be 30 percent of the income limit for a three-person, low-income household.

Under the credit program, gross rent excludes certain amounts, including Section 8 rent subsidies. Gross rent <u>includes</u> a utility allowance for tenant-paid utilities. In addition, tax credit units must generally have an initial lease term of at least six months. (Monthly leases are permitted for single-room occupancy units, or SROs.)

Compliance Periods

There are significant differences between the compliance periods for tax-exempt bonds and for credits. For both, the compliance period is the shortest amount of time during which the minimum set-aside test must be satisfied. With bonds, the compliance period begins earlier and may last longer than for credits.

For bond projects, the compliance period is called the "qualified project period." This period begins on the date on which 10 percent of the project's units are first occupied, and ends on the later of: (1) 15 years after the date on which 50 percent of the units are first occupied; (2) the first day on which no bonds are outstanding; or (3) the termination date of any HUD Section 8 rental subsidy contract for the property.

For bond projects, once 10 percent of the units are occupied, the project must continuously satisfy the minimum set-aside election (i.e., 20/50 or 40/60). For example, in a 100-unit bond project where the first 10 units have been leased to market-rate residents, no more units may be rented to market-rent tenants until the minimum set-aside test has been met. In this project, a more ideal strategy would be to rent 2 or 4 of the first 10 apartments to low-income households, in order to allow lease-up to continue expeditiously.

The compliance period for a tax credit project, on the other hand, begins on the first day of the taxable year in which the credits are first claimed (i.e., the credit period), and ends 15 years later. However, projects with post-1989 credit allocations must have extended use agreements that extend the low-income use period for another 15 years. [Note: Some states impose longer compliance periods than the federal 15-year minimum.]

In a credit project, the set-aside election must be met by the end of the first taxable year of the 10-year credit period. The credit period begins the year in which the project is placed in service or, if the owner elects, the next year.

Another thing to remember is that bond documents also impose deadlines for construction completion and lease-up. These deadlines are much stricter under the tax credit program.

Rules Regarding Students

Tax credit program rules deny credits for units occupied entirely by full-time students, unless one of four exceptions applies. Property managers, therefore, must be fully versed in the program rules regarding students.

Bond documents, on the other hand, usually only treat as low-income those households – with students – in which the occupants are married and eligible to file a joint federal tax return. Keep in mind, though, that this rule applies only to the units that are part of the set-aside election. Accordingly, once the set-aside test has been met, the student rule isn't an issue for bond purposes.

For projects with both credits and bonds, however, the credit rules relating to students are the ones that should be followed. However, if the number of qualified low-income units ever falls below the selected set-aside percentage, both the credit and bond student requirements will have to be met.

Asset Rules

Bond-financed projects are usually subject to HUD Section 8 program rules governing the determination of the income of low-income households. For this reason, households occupying units in bond projects included in the set-aside percentage must have all of their assets verified.

The credit program requires asset verification only for households with total assets in excess of $5,000.

Since the bond rule is stricter, it is the rule that generally must be followed on properties combining bonds and credits. If the bond-issuing agency waives the requirement to verify all assets, then the credit rule may be followed.

Next Available Unit Rule

One of the most confusing (but important) conflicts between the bond and tax credit rules involves the "next available unit rule."

This rule provides that once the income limit of an existing resident rises above 140 percent of the applicable income limit for a qualified low-income household, the resident's unit will not cease to be treated as a low-income unit if the next available unit of comparable or smaller size is rented to a qualified low-income household.

This rule, however, is applied on a building-by-building basis for tax credit purposes but on a project-wide basis for bonds. The following example illustrates the difference in impact:

A 100-unit, two-building project subject to the 40/60 set-aside test for both credits and bonds has 80 units occupied by qualified low-income households. A resident of Building "A" is recertified with an income above 140 percent of the income ceiling for a qualified low-income tenant. In this example, since the actual number of low-income units (80) is well above the minimum (40) required by the set-aside election, the bond program's next available unit rule doesn't apply. However, since the property must maintain 80 low-income units for credit purposes, the next available unit in Building "A" of comparable or smaller size must be rented to a qualified low-income household.

In a variation, assume the 100-unit project has only 40 units occupied by low-income residents (the minimum required by the set-aside test). Here, the next available unit rule applies for both bond and credit purposes. Consequently, if a low-income resident of Building "A" is recertified with an income above the 140 percent threshold, but the next unit of comparable or smaller size that becomes available is in Building "B," this vacant unit in Building "B" must be rented to a qualified low-income household to satisfy the bond rule. However, the tax credit rule still applies. As a result, the next available unit of comparable or smaller size in Building "A" will also have to be rented to a qualified low-income household.

The next available unit rule is very confusing to many managers – even more so for properties combining bonds and credits. For this reason, managers should seek additional guidance whenever an existing low-income resident recertifies with an income above 140 percent of the current allowable income. A mistake here can be very costly in terms of credits, especially since it is a non-correctable error.

One final thing to remember is that in deep rent-skewed projects, the next available unit rule is applied slightly differently.

Correction of Noncompliance

Correcting noncompliance with bond program requirements is relatively easy. Provided an effort is made to correct the error(s), the tax-exempt status of the bonds will stay intact. Loss of the tax exemption will only be a threat if the borrower refuses to correct the noncompliance.

Under the tax credit program, on the other hand, the IRS can impose tough penalties for noncompliance, even when corrected. For example, if a unit is occupied by a non-qualified student household for two years before detection of this fact by management, that unit won't be entitled to credits for those two years, even if management moves out the student household and rents the unit to a qualified new tenant.

Assignment of Units

One of the few areas where the bond rules are stricter than those for credits is in the manner in which units may be assigned to low-income residents in a mixed-income project.

In a bond project, the low-income units must be dispersed across all unit types evenly. For example, if 60 percent of all of the units in a project are beautiful three-bedroom apartments with luxury appliances and fireplaces, 60 percent of the low-income tenants must be placed in these units.

This is not the case in a tax credit property, due to the calculation of the applicable fraction, which is the lesser of (1) the number of low-income units as a percentage of all residential units in the building, or (2) the total floor space for the low-income units as a percentage of the total floor space for all the residential units. This calculation prevents claiming credits for space not occupied by low-income residents. Thus, on a credit property with bonds, owners may not assign residents just to the smallest units or least desirable units in the property.

Conclusion

Clearly, there are enough differences between bond and credit rules that managers and developers must be familiar with both in order to succeed. For this reason it's critical that the documents relating to both programs be carefully reviewed as a project proceeds through development and into management.

It's also important to be aware of any multiple-review requirements. It's not unusual for the housing credit agency and bond issuer to be different entities, each with its own requirements. Even when the bonds and credits are administered by the same agency, there may be separate departments within the agency applying different review procedures. This is why the most important early step in managing a property with both tax credits and bonds is to review the documents relating to each program. This will at least get management off on the right foot, and make what is sure to be a complex management problem at least manageable.

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Additional Differences

Following are some additional differences in requirements for housing tax credits and tax-exempt bonds:

- **Rehabilitation Requirement.** The minimum level of rehabilitation expenditures that must be incurred during a designated 24-month period is 10 percent of the depreciable costs of a building for tax credits, but 15 percent for bonds.
- **10-Year Rule.** An existing building may not have been previously placed in service during the past 10 years to qualify for the 4 percent tax credit for acquisition costs. No similar restriction applies regarding eligibility for bonds.
- **Project Types, Multiple Buildings.** The tax credit program provides special rules for multiple-building projects for purposes of meeting the set-aside test; for projects of smaller than five units; and for scattered-site projects.
- **Compliance Monitoring Requirements.** The tax credit program, but not the bond program, has special requirements for ongoing and mandatory site and tenant file inspections and reviews for existing projects, and the retention of certain first-year records.
- **Carryover Test.** The 10 percent carryover test applicable to projects with tax credit allocations doesn't apply to 4 percent, bond-financed projects.

Tax Credit Advisor **newsletter, April 2002**

Combining Tax Credits and Tax-Exempt Bonds: Understanding the Differences

Part 2 of 2

By A. J. Johnson

In Part 1 of this article *(Tax Credit Advisor, January 2002)*, we reviewed the major requirements to be familiar with when managing low-income housing tax credit properties financed by tax-exempt bonds. This month we examine the use of tax credits with four other popular federal housing programs: HOME; HOPE VI; Section 8; and Section 515.

HOME Program

Under the HOME Investment Partnerships program (HOME Program), the U.S. Department of Housing and Urban Development (HUD) allocates funds to states and localities (i.e., participating jurisdictions, or PJs) to address housing needs. The PJs award the funds (as grants, loans, rental assistance) to qualified recipients for eligible affordable housing activities. The latter include new rental housing construction and rehabilitation, acquisition, site work, conversion and demolition, rental assistance, and relocation.

The HOME program has its own special tenant income and rent restrictions.

Special rules apply to project units classified as HOME-assisted units (HOME units). The percentage of total project units that are HOME units is usually equal to the amount of HOME funds as a percentage of the total development cost. PJs, however, may set a higher percentage. For example, if 20 percent of the total funding for a project comes from a loan of HOME funds, 20 percent of the project's units will be HOME units.

None of the HOME units in a project may have rents that exceed the lesser of (1) the local HUD Section 8 Fair Market Rent, or (2) 30 percent of 65 percent of area median income (AMI), adjusted for family size.

For purposes of the rent computation, household size is based on the number of bedrooms in a unit, the same method used in the tax credit program. HOME rents include any tenant-paid utilities.

At least 20 percent of the HOME units in a project must be rented to households at or below 50 percent of AMI, adjusted for family size, and must have "low HOME rents." "Low HOME rent" is almost always set at 30 percent of 50 percent of AMI, though PJs may set the cap at 30 percent of the tenant's income.

The remaining 80 percent of the HOME units must be rented to households with incomes not exceeding 80 percent of AMI. Because this surpasses the tax credit program income ceiling (i.e., 50 or 60 percent of AMI), the tax credit program income limits must be followed for credit units that are HOME-assisted. If the tax credit 40/60 set-aside has been elected, at least 20 percent of the HOME units (if any) must be rented to households at 50 percent of AMI.

HOME income and rent restrictions must be maintained for a minimum compliance period that varies according to construction and loan type. For rehabilitation projects, this minimum period is: 5 years, if the amount of HOME subsidy is less than \$15,000/unit; 10 years, \$15,000-40,000/unit; and 15 years, above \$40,000/unit. For new construction, the term is 20 years (or the term of the mortgage, if financed by an FHA-insured loan).

HOME units may be either "designated" or "floating" – the PJ chooses. Designated units are particular rental units identified by the PJ that remain as HOME-assisted units through the HOME compliance period. "Floating units" are a set number of units stipulated by the PJ that "float" throughout the project and need not be the same units from year to year.

The tax credit program has a special rule that allows the 9 percent tax credit for construction or rehabilitation expenditures for a project assisted by HOME funds. To qualify for the 9 percent credit, 40 percent or more of the units <u>in each building</u> must be occupied by households at or below 50 percent of AMI, adjusted for family size. [Note: If the project is located in a high-cost area (i.e., qualified census tract or difficult development area), it can't also qualify for the usual 30 percent "step-up" in eligible basis.]

The special 40/50 set-aside requirement may be avoided – and the 9 percent credit still claimed – by (1) loaning the HOME funds at an interest rate at or above the Applicable Federal Rate (AFR), or (2) excluding the HOME funds from eligible basis.

The manager of a credit-assisted HOME project should be aware of certain additional rules that can affect ongoing management and compliance.

If the income of a resident of a "designated" HOME unit rises above 80 percent of AMI, the <u>next available HOME unit</u> must be rented to a HOME income-eligible tenant. If the HOME unit is "floating," the <u>next available unit</u> in the project must be rented to a HOME-eligible tenant.

If the income of a resident of a "low HOME" unit rises beyond 50 percent but doesn't exceed 80 percent of AMI, the next available unit in the project must be rented to a tenant at 50 percent of AMI at the low HOME rent.

Managers and owners should take particular care in filling vacant units so that they maintain compliance with both the HOME and tax credit program rules (including the latter's vacant unit and next available unit rules), so that they don't jeopardize the loss or recapture of the credit.

HOPE VI

HUD's HOPE VI program provides grants to public housing agencies (PHAs) to replace deteriorated public housing units with new or renovated public housing units – usually as part of a broader mixed-income residential community built by a for-profit sponsor.

HOPE VI and other public housing capital funds may be used to revitalize or redevelop the public housing units within such projects, which normally are owned by an entity other than the PHA. In addition to public housing units (which generally also are tax credit-qualified), these developments usually also contain non-public housing tax credit units and market-rate rental units.

Public housing residents can't have incomes greater than 30 percent of AMI. A federal operating subsidy is provided to the PHA for the public housing units for up to 40 years under an annual contributions contract (ACC) from HUD. It subsidizes the operating costs for the units beyond what the residents pay, which is no more than 30 percent of income.

HOPE VI projects are subject to a regulatory agreement that sets forth the unit mix for the public housing units. This agreement normally specifies the number of units of different sizes (i.e., number of bedrooms) that must be reserved for public housing residents. These units may not be limited to certain buildings; they must be scattered throughout the development. This differs from the tax credit program, which permits separate low-income and market-rate buildings.

The PHA must maintain a waiting list for the public housing units in a HOPE VI project. It addition, it must establish, for such units, a Resident Selection and Assignment Plan, Affirmative Fair Housing Marketing Plan (AFHMP), and Grievance Procedures.

A PHA may not impose any requirements on a HOPE VI project that would risk a tax credit program violation.

Section 8 Rental Assistance

HUD's Section 8 rental assistance program has two separate components: vouchers and project-based Section 8. Both are administered by PHAs or other eligible local agencies. The particular type of Section 8 at a property largely determines the specific rules that the manager must follow.

The maximum income limit for all new tenants under Section 8 is 80 percent of AMI. However, 95 percent of new tenants must have incomes of 50 percent or less of AMI.

The rent limit for Section 8 units is the HUD Fair Market Rent. Section 8 residents pay up to 30 percent of their income toward rent.

Vouchers

The Section 8 "Housing Choice Voucher Program" provides a "portable" rent subsidy. In other words, the resident receiving the voucher may use it for any apartment which meets the PHA's requirements (i.e., habitability standards) and has an owner that who accepts vouchers.

In most areas, owners/managers of conventional apartment projects can choose whether to participate in the voucher program. Tax credit owners/managers, on the other hand, may not refuse to rent to a household just because they hold a voucher.

The same screening criteria (e.g., credit, criminal background checks) applied to other applicants must be used for voucher applicants. In addition, voucher users can't be held to a higher standard than other applicants.

The voucher amount must be considered in determining an applicant's rent-paying ability.

Voucher applicants are subject to the same income limits that apply to all tax credit unit applicants (i.e., 40 or 60 percent of AMI, adjusted for household size). This is important, because the Section 8 income limit (80 percent of AMI) is higher than the tax credit income ceiling. While unusual, there are cases where a voucher applicant may have an income too high for a Section 42 property. This means all voucher applicants must have their income verified. These income verifications must meet the same standards applicable to all other tax credit applicants, with one exception. Managers may accept an income verification from the PHA for a voucher applicant. This verification must show the applicant's gross income (not adjusted): It may not merely say the applicant is "eligible."

Another difference: Units occupied by voucher recipients must use the local PHA's utility allowance, unless the project is subject to a regulatory agreement from HUD or the federal Rural Development Service. This means any private utility company estimate obtained for a tax credit project may only be used for units not occupied by voucher holders.

A credit project, though, doesn't need to accept voucher applicants if the tax credit unit rental charge exceeds the local PHA's "rent standard" – the maximum rent for a voucher-eligible unit. For example, if the monthly tax credit rent for a two-bedroom unit is $700 but the voucher rent standard is $650, the owner needn't approve a voucher applicant for residency because this would force the owner to accept a reduced rent. An owner, on the other hand, <u>may choose</u> to accept a lower rent for a voucher holder (e.g., to boost occupancy).

Project-Based Section 8

Project-based Section 8 rental assistance is "attached" to a project. If the tenant moves, the subsidy remains with the unit.

The tax credit and project-based Section 8 programs have slightly different certification requirements. Therefore, the owner/manager must make sure that the certification requirements for both programs are met for all applicants/residents.

HUD's certification (Form 50059) must be used when certifying an applicant/resident for Section 8 eligibility. This form, which shows both "gross" and "adjusted" income, is used to calculate the tenant's rent contribution. Unless the state housing credit agency permits use of this form, a separate tax credit certification must be used. Even where HUD Form 50059 is used, managers will need to develop a separate certification regarding student status to satisfy tax credit program rules. HUD's certification doesn't address student status.

Owners planning to acquire an existing Section 8 project and seek credits should recognize that some existing residents may have incomes exceeding the credit program's ceiling. Over-income residents can't be evicted, and their units won't qualify for credits. Accordingly, a wise course is to survey the incomes of existing residents early in the development process.

The project-based Section 8 program requires that at least 40 percent of project units be rented to tenants at or below 30 percent of AMI. The remaining units must be occupied by households at or below 80 percent of AMI. Here again, managers must make sure that applicants have incomes within the applicable tax credit ceiling (50 or 60 percent of AMI, adjusted for family size), in order to assure that all the units qualify for tax credits.

Certain HUD allowances are subtracted from gross income to determine the adjusted income of a resident of a project-based Section 8 project for rent calculation purposes. These allowances, for certain household characteristics, include for the number of dependents, elderly or disability status, medical expenses, and child care costs.

Rural Development Section 515

The Section 515 program, administered by the federal Rural Development Service (RD), provides low-interest permanent mortgages to developers to finance development of rural rental housing projects.

Program rules bar RD from imposing any requirement that would prevent a Section 515 project owner from obtaining tax credits. This effectively prevents RD from forcing owners to follow RD regulations that could negatively affect tax credit compliance. The best example of this is income limits. Section 515 income limits are higher than the tax credit program's income limits. Therefore, owners of credit-assisted Section 515 projects could be forced into non-compliance with tax credit program rules if their owners were forced to accept applicants with incomes as high as the greater, RD limits.

This same RD regulation, however, doesn't let owners ignore other Section 515 program rules. Therefore, when the tax credit and Section 515 rules conflict, the more stringent requirement must be followed.

One major conflict exists for projects with pre-1991 tax credit allocations. Here, RD rules require Section 515 residents to pay the greater of a "basic rent" or 30 percent of adjusted income – up to a "note rate" rent cap. If the note rate rent exceeds the maximum tax credit program rent, and if 30 percent of the tenant's income exceeds the maximum tax credit rent, the resident need only pay up to the tax credit rent. However, RD requires the owner to pay it the excess of the tax credit rent over 30 percent of income – called "overage."

For example, assume a Section 515 project two-bedroom unit with a basic rent of $350 and note rate rent of $600. To satisfy RD requirements, a resident without rental assistance would have to pay a monthly rent of at least $350 (the basic rent) but not more than $600 (the note rate rent). Now assume the maximum monthly tax credit rent for a two-bedroom unit is $550. Given these facts, an existing resident recertified with an adjusted income of $22,800 would be required by RD rules to pay a monthly rent of $570 (30% of $22,800, divided by 12). However, because the maximum tax credit rent is $550, the owner could collect only $550 from the resident. But the owner would still have to make an additional overage payment of $20 ($570 minus $550) to RD.

Tenants of Section 515 properties with post-1990 credit allocations must pay the full amount of overage in addition to the tax credit rent, or $570 in the preceding example.

RD-assisted properties must use RD utility allowances only.

Income eligibility of residents of Section 515 properties is determined using RD procedures virtually identical to those of the Section 8 program – the set used in the credit program.

RD requires asset verification for all Section 515 residents and has its own certification form. Therefore, two certifications – one for RD and the second for the credit program – are likely to be required for projects benefiting from both subsidies. RD requires an immediate recertification if a household's circumstances or income change during a certification year.

A. J. Johnson is president of A. J. Johnson Consulting Services, Inc., a Newport News, VA-based full service real estate consulting firm specializing in due diligence and asset management issues, with an emphasis on low-income housing tax credit properties. He may be reached at 757-599-3964.

CCA 200137044 - IRC Section 42 - Low-Income Housing Credit

IRC Section 42
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MEMORANDUM FOR Sharon M, Oliver
Director, Reporting Compliance S:C:CP:RC

FROM: Harold Burghart
Assistant to the Chief, Branch 5 CC:PSI:5

SUBJECT: Low Income Housing Credit: Clarification of § 42(l)(1), Certification With Respect to 1st Year of Credit Period.

This Chief Counsel Advice responds to your memorandum dated April 2, 2001. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent. Your memorandum concerns certain questions under § 42(l)(1) and Form 8609, Low-Income Housing Credit Allocation Certification. These questions are summarized below.

Q1. When is a building placed in service and how can this be documented?

Q2. Once a Form 8609 is first issued by an applicable allocating authority, can the taxpayer file an amended return to claim credits for taxable years in a building's compliance period prior to the issuance of the Form 8609?

Q3. If a taxpayer has claimed § 42 credits for any year prior to the issuance of the Form 8609,can all credits claimed prior to the issuance of the Form 8609 be disallowed?

Q4. Can a taxpayer satisfy the certification requirements of § 42(l) during the examination process?

Q5. If a revenue agent finds that the first year certification requirements of § 42(l)(1) have not been met, can the entire credit amount for the first and all successive years be disallowed?

LAW & ANSWERS

Section 42(l)(1) provides that following the first year of the credit period for any qualified low-income building, the taxpayer shall certify to the Secretary (at such time and in such form and in such manner as the Secretary prescribes)

(a) the taxable year, and calendar year, in which the building was placed in service,

(b) the adjusted basis and eligible basis of the building as of the close of the 1*st* year of the credit period,

(c) the maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate housing credit agency under § 42(h),

(d) the election made under § 42(g) for the qualified housing project of which such building is a part (i.e., the "minimum set-aside requirement"), and

(e) such other information as the Secretary may require.

In the case of a failure to make the certification required by the preceding sentence on the date prescribed therefore, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable under § 42(a) to such building for any taxable year ending before such certification is made.

Section 42(l)(2) provides that the Secretary may require taxpayers to submit an information return (at such time and in such form and manner as the Secretary prescribes) for each taxable year setting forth

(a) the qualified basis for the taxable year of each qualified low-income building of the taxpayer,

(b) the maximum applicable percentage and qualified basis permitted to be taken into account by the appropriate housing credit agency under § 42(h) for the taxable year, and

(c) such other information as the Secretary may require.

The penalty under § 6652(j) shall apply to any failure to submit the return required by the Secretary under the preceding sentence on the date prescribed therefor.

Section 1.42-1T(d)(8)(ii) of the Income Tax Regulations provides that credit allocations are made when Part 1 of Form 8609 is completed and signed by an authorized official of the housing credit agency and mailed to the owner of the qualified low-income building.

Section 1.42-IT(h)(1) provides that a form shall be treated as completed if the state or local housing credit agency or the building owner has made a good faith effort to complete the form in accordance with the form and the form's instructions.

Section 1.42-IT(h)(2) provides that a completed Form 8609 (or copy thereof) shall be filed with the owner's Federal income tax return for each of the 15 taxable years in the compliance period. For tax-exempt bond financed projects for which no allocation is made, an owner is to obtain a blank copy of Form 8609 and fill in the address of the building and the name and address of the owner.Part II of Form 8609 is to be completed by the building owner only for the first year the low income housing credit is claimed by the building owner. Part III of Form 8609 (Statement of Qualification)shall be completed by the owner of the building for each year of the 15-year compliance period.

Section 1.42-IT(h)(3) provides that if any form is revised or renumbered, any reference in this section to the form shall be treated as a reference to the revised or renumbered form.

The instructions to Form 8609 provide that an owner must get a Form 8609 from the appropriate housing credit agency (with the applicable items of Part 1, completed, including an assigned building identification number (BIN)).

Enumerated below are our answers to your questions.

A1. Notice 88-116, 1988-2 C.B. 449, provides guidance on when a building will be considered to be placed in service for purposes of § 42. It provides that the placed-in-service date for a new or existing building used as residential rental property is the date on which the building is ready and available for its specifically assigned function, i.e., the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law. See the notice for rules on rehabilitation expenditures treated as a building. A building may be placed-in-service even if the rental units in it are not currently occupied by low-income tenants.

Documentation of a building's placed-in-service date is generally fact specific. For example, for new buildings, a temporary certificate of occupancy (TCO) might provide adequate documentation if the local jurisdiction that issues the TCO requires that the building be habitable at the time the TCO is issued.

A2. Once a Form 8609 is issued by the applicable allocation authority, the taxpayer can file an amended return to claim credits for taxable years in a building's compliance period prior to the year in which the Form 8609 is issued.

A3. Under certain circumstances, if a taxpayer claimed § 42 credits for a year prior to issuance of the Form 8609 by the applicable allocating authority, all credits claimed prior to issuance of the Form 8609 can be disallowed.

Section 1.42-IT(h)(1) provides that a form is not completed unless the state or local housing agency or the building owner has made a good faith effort to complete the form in accordance with the form and the instructions for the form. Form 8609 provides that Part 1 is to be filled out by the housing credit agency only. Section 1.42-IT(h)(2) provides that a completed Form 8609 (or copy thereof) shall be filed with the owner's Federal income tax return for each of the 15 taxable years inthe compliance period (which encompasses the first year of the credit period). This requirement cannot be satisfied in the case of an incomplete Form 8609. If, in the case of an allocation from the state housing credit ceiling, the state agency has not completed Part 1, the form is incomplete. Since the first-year certification requirement of § 42(l)(1) is incorporated into Form 8609, an incomplete form under these circumstances would not satisfy the § 42(l)(1) first year requirement. The flush language following § 42(l)(1)(E) provides that in the case of a failure to make the certification required by § 42(l)(1) on the date prescribed thereof, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable under § 42(a) for any taxable year before such certification is made. If the failure to meet the § 42(l)(1) certification requirement is a result of the taxpayer's willful neglect, credit may be disallowed for any open years(assuming no fraud) in the compliance period until this requirement is met.

The above paragraph pertains to buildings that receive a credit allocation from the state housing credit ceiling. It is not clear what the result would be for a tax-exempt bond project. Section 1.42-IT(h)(2) provides that for tax-exempt bond financed projects for which no allocation is made, an owner is to obtain a blank copy of Form 8609 and fill in (for Part 1) the address of the building and the name and address of the owner. This requirement is inconsistent with the Form 8609 instructions that Part 1 is to completed by the housing credit agency only and post 1986 amendments to § 42 that provide an implicit oversight responsibility by the applicable state housing credit agency (see e.g., §42(m)).

A4. There is no prohibition against satisfying the certification requirements of § 42(l) during the examination process.

A5. The answer to whether the entire credit amount for the first and all successive years can be disallowed if the first-year certifications requirements of § 42(l)(1) have not been met is similar to that in A3. The flush language following § 42(l)(1)(E) provides that in the case of a failure to make the certification required by § 42(l)(1) on the date prescribed thereof, unless it is shown that such failure is due to reasonable cause and not to willful neglect, no credit shall be allowable under §42(a) for any taxable year before such certification is made. If the failure to meet the § 42(l)(1)certification requirement is a result of the taxpayer's willful neglect, credit may be disallowed for any open years (assuming no fraud) in the compliance period until this requirement is met.

If you have any questions about this memorandum or further questions about these issues, please call Christopher Wilson at (202) 622-3040.